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AUG - 6 1991

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Technical Coordination Report 17,896
TR-45-927-91

This is in response to the above-referenced technical coordination report prepared by Mr. Bruce Danz. This technical coordination report questions the propriety of permitting a United States taxpayer to claim the credit for increasing research activities under section 41 of the Internal Revenue Code for research expenses which are reimbursed by a foreign parent. Mr. Danz's concern was prompted by a case currently under examination.

As Mr. Danz points out, in PLR 8914026 (January 3, 1989) the National Office ruled on substantially similar facts. This case involved research conducted by a wholly-owned domestic subsidiary corporation of a foreign parent corporation.[1] In this ruling, the foreign parent and its wholly-owned domestic subsidiary entered into a research contract, under which the domestic subsidiary would perform research for the foreign parent. The foreign parent would reimburse the domestic subsidiary for its cost of conducting the research. The research would be conducted in the United States. The issue in the private letter ruling was whether the expenses incurred in conducting the research were the qualified research expenses of the domestic subsidiary. The National Office ruled that because the foreign parent and the domestic subsidiary were members of the same controlled group, the foreign parent's reimbursement of its wholly-owned domestic subsidiary's research expenses was not considered funding under section 41(d)(4)(H) of the Code. We believe this ruling is consistent with the purpose underlying section 41(d)(4)(H) and (f)(1).

Mr. Danz believes that permitting a United States taxpayer to claim the credit under section 41 of the Code for research expenses reimbursed by a foreign parent is abusive, because such reimbursed research expenditures should be treated as funded research and thereby excluded from the definition of qualified research eligible for the credit under section 41(d)(4). To

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[1] See also PLR 8945029 (August 15, 1989), and TAM 8643006 (July 23, 1986).

prevent this perceived abuse, Mr. Danz suggests that section 41(f)(5) be amended to incorporate section 1563(b) and thereby exclude foreign corporations from the definition of the term "controlled group of corporations" for purposes of computing the credit under section 41.

Section 41 of the Code provides a nonrefundable income tax credit for certain research and experimental expenditures paid or incurred by a taxpayer during the taxable year. The credit is based on the amount by which the taxpayer's qualified research expenses for the taxable year exceed the taxpayer's base period research expenses.

Only amounts paid or incurred with respect to qualified research are eligible for the credit, section 41(b) of the Code. Section 41(d) defines the term "qualified research" as research with respect to which expenditures may be treated as expenses under section 174, which is undertaken for the purposes of discovering information which is technological in nature, and the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and substantially all of the activities of which constitute elements of a process of experimentation for a purposes described in section 41(d)(3).

Section 41(d)(4)(H) of the Code excludes from the definition of the term "qualified research" research to the extent funded by any grant, contract, or otherwise by another person (or government entity). Even though the research expenses described in TCR 17,896 and PLR 8914026 are reimbursed by the foreign parent corporations, the research is not funded research within the meaning of section 41(d)(4)(H). Section 41(f)(1) and section 1.41-8(a)(1) of the Income Tax Regulations require that for purposes of determining the amount of the research credit, all members of the same controlled group of corporations are to be treated as a single taxpayer. The proportionate share of research credit allowable to any member of the controlled group is equal to that member's proportionate share of the increase in qualified research expenses giving rise to the credit.

Section 41(f)(5) of the Code provides that, for purposes of section 41, the term "controlled group of corporations" has the same meaning as that given to such term by section 1563(a) of the Code, except that "more than 50 percent" shall be substituted for "at least 80 percent" each place it appears in section 1563(a)(1). Under section 1563(a)(1) of the Code a parent-subsidiary controlled group exists where one or more chains of corporations are connected through stock ownership with a common

parent corporation if the percentage of ownership requirements are met with regard to each corporation in the group.

Section 1563(b) of the Code defines the term "component member of a controlled group of corporations." Generally, a corporation is a component member of a controlled group of corporations if such corporation is a member of such controlled group of corporations and is not treated as an excluded member. Under section 1563(b)(2)(C), foreign corporations subject to tax under section 881 are excluded members of a controlled group of corporations.

For purposes of section 41(f)(5) of the Code, the term "controlled group of corporations" means two or more corporations connected through stock ownership as described in section 1563(a). Neither section 41(f)(5) nor section 1563(a) incorporates section 1563(b) in its definition. Thus, for purposes of section 41(f)(5), a controlled group of corporations include members of the controlled group within the meaning of section 1563(a), regardless of whether such members are component members or excluded members under section 1563(b). This rule is consistent with our interpretation of a similar rule for purposes of the targeted jobs credit under section 52.[2] See Notice 88-86, 1988-2 C.B. 401, 406, and PLR 8022005 (February 12, 1980). As Mr. Danz recommends, a legislative amendment is necessary to exclude foreign corporations from the definition of the term "controlled group of corporations" for purposes of section 41.

The failure of section 41(f)(5) of the Code to incorporate section 1563(b) in its cross-reference to section 1563(a) for the definition of a controlled group of corporations permits a foreign corporation to be treated as a member of a controlled group. Under section 41(f)(1)(A), all the members of the controlled group are treated as one taxpayer for purposes of the research credit. Accordingly, a foreign corporation's reimbursement of research expenditures made by another member of the group will not be treated as funded research. Mr. Danz does not agree with this result and requests that the statute be amended to preclude a U.S. taxpayer whose research expenditures are reimbursed by a foreign corporation from qualifying for the credit. To avoid this result, it is suggested that section

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[2] For purposes of the aggregation rules, the drafters of section 41 of the Code intended to adopt the same controlled group test that applies for purposes of the computing the targeted jobs credit under section 52. See H. Rept. No. 97-201, 97th Cong., 1st Sess. 123, 1981-2 C.B. 364.

41(f)(5) be amended to exclude members described in section 1563(b) from the definition of the term "controlled group of corporations."

The suggested legislative amendment sought by Mr. Danz to the definition of the term "controlled group of corporations" would have the effect of treating a member of a controlled group that is a foreign corporation as a separate taxpayer for purposes of the research credit. In this way, the reimbursement by the foreign corporation of the research expenditures made by another member of the controlled group would be characterized as funded research. However, we have reservations with the proposed legislative change because the proposed statutory change would give rise to a potential abuse that Congress specifically sought to address in section 41(f)(1) of the Code. The aggregation rules in section 41(f)(1) of the Code were enacted to ensure that the credit would be allowed only for actual increases in research expenditures. These rules are intended to prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related persons. See H. Rept. No. 97-201, 97th Cong., 1st Sess. 123, 1981-2 C.B. 364. In the case of a foreign corporation with a division conducting research in the United States, this abuse could occur. Defining a controlled group of corporations to exclude a foreign corporation would permit a foreign corporation to be treated as a separate taxpayer and thereby allow it to shift expenditures from its U.S. division to another member of the group under its common control which would artificially increase the research expenditures of such member.

An alternative method of denying the credit to the group member conducting the research is to allocate the credit to the group member funding the research. Under the general rule of section 1.41-8(a) of regulations, the credit allocated to a member of the controlled group is based on the member's proportionate share of the increase in the qualified research expenses of the aggregated group. In order to avoid manipulation of the credit between members of a controlled group, the drafters of the regulations under section 41 of the Code did consider attributing research expenses to the group member who actually funded the research. However, it was determined that, if the expenses were attributed to the payor, a more serious abuse would exist. First, it was determined that the expenses of the group could be artificially increased by having the payor member pay another member of the group exorbitant amounts to perform research. In addition, if members of the group had different tax years and the credit were computed on the basis of the expenses of the payor member, artificial increases in the expenses of the

group could be created by changing the payor member from year to year. In order to avoid these abuses, the rules governing the allocation of qualified research expenses incurred in intra-group transactions were adopted. See section 1.41-8(e) of the regulations.

We hope that this information is helpful to you and Mr. Danz in understanding our position on changing the applicable law as it relates to the issue addressed in his TCR. Since Mr. Danz's suggestion requires a legislative amendment, we have forwarded a copy of the TCR and this memorandum to the Legislative Affairs Division for their information. If we can be of further assistance, please contact this office.

Sincerely yours,

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